



**U.S.-China Economic and Security Review Commission**  
**Staff Report**

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**The Risks of China's Internet Companies on U.S. Stock Exchanges**

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China's leading private Internet companies are turning to U.S. stock exchanges to raise funds for expansion. Unable to access sufficient capital from China's state-owned banking system or from its undersized bond market, Chinese Internet companies must rely on foreign investors to keep their businesses operating and growing.<sup>1</sup> However, the Chinese government restricts foreign investment in its Internet sector through foreign equity caps and complex licensing requirements.<sup>2</sup> Moreover, most private Chinese companies must obtain permission to list overseas.<sup>3</sup> To bypass these restrictions, Chinese Internet companies use a complex and highly risky mechanism known as a Variable Interest Entity (VIE). VIEs, usually based in tax havens such as the Cayman Islands, are essentially holding companies that link foreign investors and Chinese firms via a set of complex legal contracts.<sup>4</sup> In theory, the VIE structure guarantees that economic benefits flow to the foreign investors; meanwhile operating control of the business remains within the Chinese firm, ostensibly to comply with Chinese laws.<sup>5</sup>

U.S. shareholders face major risks from the complexity and purpose of the VIE structure. For example, the legal contracts that serve as the basis of the structure are enforceable only in China, where rule of law remains rudimentary.<sup>6</sup> Though listing VIEs on U.S. exchanges is legal in the United States, they can be considered illegal in China. As Internet giants Alibaba, Baidu, and Weibo become synonymous with "Chinese Amazon," "Chinese Google," and "Chinese Twitter," risks could mount for unsuspecting U.S. investors who buy into their precarious VIE structures.<sup>7</sup>

### **China's Internet Firms Flock to U.S. Exchanges**

A recent wave of Chinese Internet companies launching initial public offerings (IPOs) on U.S. exchanges has raised misgivings among U.S. regulators.<sup>8</sup> In May 2014, Alibaba, China's leading e-commerce website, filed for a U.S.-based IPO in what is expected to be one of the largest in U.S. history.<sup>9</sup> In the same month, JD.com, a Chinese retailing website, launched its IPO on the NASDAQ.<sup>10</sup> And, on April 17, 2014, Weibo, a Chinese microblog with over 140 million users, made an IPO on the NASDAQ.<sup>11</sup> In doing so, Weibo and JD.com joined the ranks of several Chinese Internet firms that already list on major U.S. exchanges (see Figure 1).

As China's leading Internet companies expand, they are unable to obtain sufficient capital domestically and are turning to foreign investors by listing on non-Chinese exchanges, most commonly in the United States.<sup>12</sup> This trend has grown despite Chinese regulations that attempt to prevent it.<sup>13</sup> It is extremely difficult for Chinese firms to obtain permission to list overseas; it is illegal in China for foreign shareholders to have a controlling interest in a China-based Internet firm.<sup>14</sup> Nonetheless, Chinese Internet companies make no secret of their overseas listings, and Chinese state-run media report on them without questioning their legality under Chinese law.<sup>15</sup> This is because Chinese firms have circumvented domestic regulations by listing overseas via a complex and highly risky scheme of legal arrangements with overseas investors via VIEs.<sup>16</sup>

Figure 1: Major Chinese Internet Firms Listed on U.S. Exchanges

Company	Stock Symbol	Primary Service	Market Capitalization (in billions) <sup>17</sup>	U.S. Exchange
<b>Baidu</b>	BIDU	Internet search	\$58.27	NASDAQ
<b>JD.com</b>	JD	E-commerce	\$33.3	NASDAQ
<b>Qihoo 360</b>	QIHU	Internet security and software	\$23.82	NYSE
<b>NetEase</b>	NTES	Web portal	\$9.24	NASDAQ
<b>Ctrip.com</b>	CTIP	Travel website	\$7.48	NASDAQ
<b>Weibo</b>	WB	Microblog	\$6.04	NASDAQ
<b>YY</b>	YY	Social network	\$3.79	NASDAQ
<b>Youku Tudou</b>	YOKU	Online video	\$3.77	NYSE
<b>Sohu.com</b>	SOHU	Internet advertising and search	\$2.26	NASDAQ
<b>Changyou.com</b>	CYOU	Online games	\$1.41	NASDAQ
<b>Renren</b>	RENN	Social network	\$1.22	NYSE

Source: Google Finance.

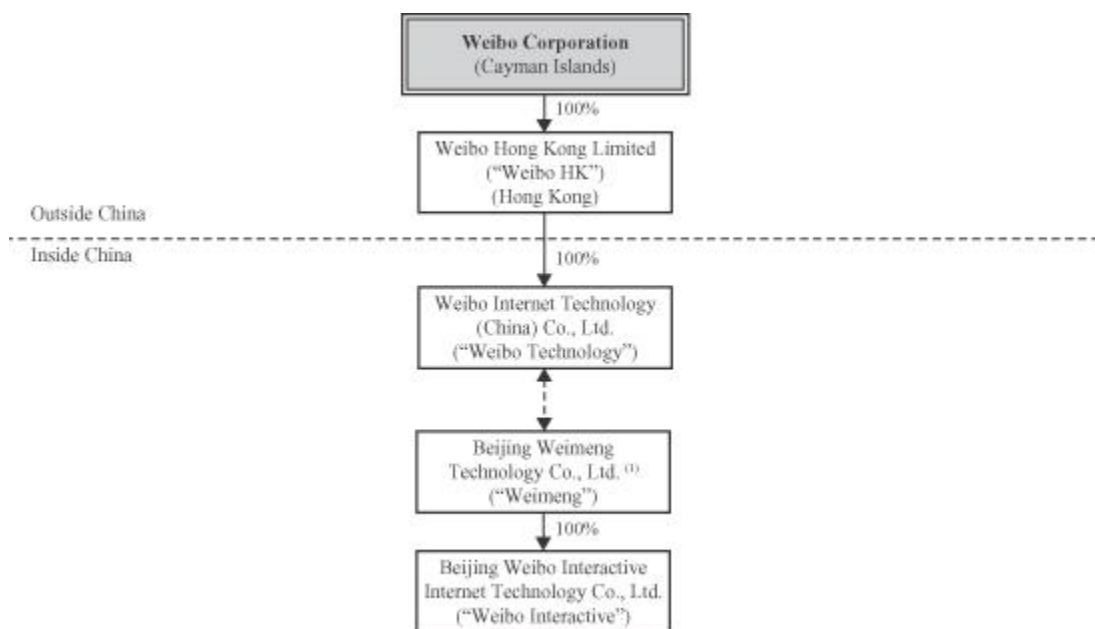
### Variable Interest Entities: A Regulatory Work-Around

All of China's major Internet companies that list on U.S. exchanges use the VIE structure as a means of circumventing Chinese restrictions on their access to foreign capital. The VIE structure is best understood by looking at a specific company case in which ownership is deliberately obscured by a series of shell companies. In the case of Weibo, a leading microblogging website in China, U.S. investors who purchase stock on the NASDAQ are buying into a company called Weibo Corporation, which is based in the Cayman Islands. According to Weibo Corporation's U.S. Securities and Exchange Commission (SEC) filing, Weibo Corporation is the sole owner of a Hong Kong-based firm called Weibo Hong Kong Limited ("Weibo HK"), which wholly owns and operates a subsidiary in China known as Weibo Internet Technology (China) Co., Ltd. ("Weibo Technology").<sup>18</sup> However, because the subsidiary Weibo Technology is wholly owned by foreign entities (Weibo Corporation and Weibo HK), it is banned from directly owning and operating a website in China, a service that is subject to foreign equity caps and various Internet-related licenses.\*

The Chinese company that actually operates the microblog Weibo (and has the requisite government licenses to do so) is called Beijing Weibo Interactive Internet Technology Co., Ltd. ("Weibo Interactive"). Weibo Interactive is wholly owned by another Chinese firm called Beijing Weiming Technology Co., Ltd. ("Weiming"), which is a VIE. As a VIE, Weiming's primary functions are to hold the equity of the primary Chinese company and engage in a series of contractual arrangements with foreign-owned Weibo Technology. (Figure 2 was included in Weibo Corporation's SEC filing and illustrates this structure.)<sup>19</sup>

\* For legal purposes in Mainland China, a Hong Kong-based company is considered a foreign entity.

Figure 2: Weibo's VIE Structure<sup>20</sup>



Source: Form F-1 Registration Statement, Weibo Corporation, U.S. Securities and Exchange Commission.

According to Weibo Corporation's SEC F-1 filing, the contractual arrangements between the foreign subsidiary Weibo Technology and the VIE Weiming include: "loan agreements, share transfer agreements, loan repayment agreements, agreements on authorization to exercise shareholder's voting power, share pledge agreements, exclusive technical services agreement, exclusive sales agency agreement and trademark license agreement."<sup>21</sup> This byzantine complex of legal arrangements allows foreign investors to invest in Weibo Interactive without maintaining direct share ownership, which would be illegal under Chinese law. These loan agreements ostensibly guarantee to the foreign-owned subsidiary Weibo Technology the profits of the VIE Weiming and the right to purchase Weiming at a pre-determined price.

In sum, this intricate ruse is a way of making the business appear to be Chinese-owned to Chinese regulators while claiming to be a foreign-owned business to foreign investors.<sup>22</sup> Neither claim is technically true, and the arrangement is highly risky and potentially illegal in China.

## Risks of Investing in VIE-based Internet Firms

The utilization of VIEs in sectors of the Chinese economy that ban or restrict foreign investment has long been the subject of debate. These sectors are typically those deemed by the Chinese government as strategic and emerging industries (SEIs)<sup>†</sup> or otherwise sensitive for political or

<sup>†</sup> First mentioned in the 12<sup>th</sup> Five-Year Plan, SEIs are industries marked by the Chinese government for development through subsidization and policy support. For more information, see U.S.-China Economic and Security Review Commission, *2011 Report to Congress* (Washington, DC: November 2011), pp. 91-94.  
[http://origin.www.uscc.gov/sites/default/files/annual\\_reports/annual\\_report\\_full\\_11.pdf](http://origin.www.uscc.gov/sites/default/files/annual_reports/annual_report_full_11.pdf).

national security reasons. Internet-related services fall under all of these categories, which explains why the vast majority of Chinese firms using VIEs to list on U.S. exchanges are in the Internet industry.

### *Legality and Enforceability of VIEs in China*

Many U.S. legal experts argue that the VIE structure is technically illegal under Chinese law, and advise U.S. investors against engaging in such investments. The risk of investing in VIEs is, in fact, described in painstaking detail in SEC filings. For example, in Alibaba's SEC Form F-1 in the section entitled "Risk Factors," the company states:

Foreign ownership of certain types of Internet businesses, such as Internet information services, is subject to restrictions under applicable PRC laws, rules and regulations. For example, foreign investors are generally not permitted to own more than 50 percent of the equity interests in a value-added telecommunication service provider.<sup>23</sup>

Nonetheless, the lure of high returns in the short-term from access to the vast and growing China Internet market appears to outweigh this risk, so U.S. investors continue to invest and Chinese firms continue to list on U.S. exchanges.

Chief among the many risks related to VIEs is the fragility of the legal contracts that are the foundation for the entire set-up. Because the legal contracts are between the wholly foreign-owned subsidiary and the VIE, both of which are established in China, the contracts are only binding and enforceable if Chinese courts are willing to uphold them.<sup>24</sup> Since the entire VIE structure is built on the premise of circumventing Chinese government regulations, relying on Chinese courts to uphold the VIE contracts in court is highly risky.

Therefore, for U.S. investors, a major risk is that the Chinese shareholder of the VIE will steal the entity, ignoring the legal arrangements on which the system is based.<sup>25</sup> In theory, the wholly foreign-owned subsidiary would then have to take the VIE to court to seek enforcement of the legal contracts. However, such a scenario is unlikely because of the high probability that the Chinese judges will not honor the contracts, though there is no evidence of legal precedence. In Alibaba's SEC Form F-1 filing, the company's legal representative explains the risks of judicial non-enforcement in detail.<sup>‡</sup>

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<sup>‡</sup> From Alibaba's SEC Form F-1 Filing: "In the opinion of Fangda Partners, our PRC counsel, the ownership structures of our material wholly-foreign owned enterprises and our material variable interest entities in China, both currently and immediately after giving effect to this offering, do not and will not violate any applicable PRC law, regulation or rule currently in effect; and the contractual arrangements between our material wholly-foreign owned enterprises, our material variable interest entities and their respective equity holders governed by PRC law are valid, binding and enforceable in accordance with their terms and applicable PRC laws and regulations currently in effect and will not violate any applicable PRC law, rule or regulation currently in effect. However, Fangda Partners has also advised us that there are substantial uncertainties regarding the interpretation and application of current PRC laws, rules and regulations. Accordingly, the PRC regulatory authorities and PRC courts may in the future take a view that is contrary to the opinion of our PRC legal counsel. It is uncertain whether any new PRC laws, rules or regulations relating to variable interest entity structures will be adopted or if adopted, what they would provide. If we or any of our variable interest entities are found to be in violation of any existing or future PRC laws, rules or regulations, or fail to obtain or maintain any of the required permits or approvals, the relevant PRC regulatory

Given that some of China's most successful new companies rely so heavily on VIEs, the Chinese government has yet to take any concrete steps to dismantle them.<sup>26</sup> However, some recent regulatory decisions indicate that VIEs may come under scrutiny if the Chinese government so chooses. In 2013, China's top judicial body, the Supreme People's Court, ruled that contractual agreements between Hong Kong and Mainland companies (referring to the VIE agreements) were clearly intended to circumvent Chinese regulations and were tantamount to "concealing illegal intentions with a lawful form."<sup>27</sup> Earlier, in 2009, the General Administration of Press and Publication (GAPP, which is now part of the State Administration of Press, Publication, Radio, Television, and Film or SAPPRFT) published a notice that the VIE structure was specifically prohibited in the online game sector.<sup>28</sup> The Ministry of Commerce and the China Securities Regulatory Commission (CSRC) have also discouraged VIEs, especially in the Internet sector.<sup>29</sup>

### **Understanding the Alibaba IPO**

The much anticipated Alibaba IPO will be the latest in the recent trend of Chinese Internet firms listing on U.S. exchanges and is expected to be among the largest IPOs in U.S. history. Like other Chinese Internet firms, Alibaba will use a VIE structure to list in the United States.<sup>30</sup> Therefore, Alibaba stock will carry the same legal risks as other Chinese VIE-structured Internet companies. Alibaba's SEC Form F-1 filing describes the legal ambiguity of its VIE and related risks bluntly:

If the PRC government deems that the contractual arrangements in relation to our variable interest entities do not comply with PRC governmental restrictions on foreign investment, or if these regulations or the interpretation of existing regulations changes in the future, we could be subject to penalties or be forced to relinquish our interests in those operations.<sup>31</sup>

In addition, Alibaba will be using a preferential stock structure that will consolidate all decision-making authority with the company's founders in China. Under this stock structure, share ownership does not equate to voting rights in the company.<sup>32</sup> According to the company's SEC filing, "This governance structure...will limit your ability to influence corporate matters, including any matters determined at the board level."<sup>33</sup>

Alibaba's controversial history, with its first major foreign investor Yahoo!, sheds light on the risks U.S. investors face in buying into Chinese Internet companies under the VIE structure. In 2010, Alibaba chairman Jack Ma spun a deal that angered foreign investors but was achievable

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authorities would have broad discretion to take action in dealing with such violations or failures, including revoking the business and operating licenses of our PRC subsidiaries or the variable interest entities, requiring us to discontinue or restrict our operations, restricting our right to collect revenue, blocking one or more of our websites, requiring us to restructure our operations or taking other regulatory or enforcement actions against us. If we are not able to restructure our ownership structure and operations in a satisfactory manner, we would no longer be able to consolidate the financial results of our variable interest entities in our consolidated financial statements. Any of these events would have a material adverse effect on our business, financial condition and results of operations."

due to the VIE structure.<sup>34</sup> Alibaba had developed an online payment tool called Alipay, a service akin to PayPal. Launching the tool was expected to have positive consequences for Yahoo! as a major investor in Alibaba. However, through the autonomy that the VIE granted to Ma, he secretly and unilaterally decided to spin off Alipay as a separate company owned solely by himself, though it was developed with Alibaba resources and supported by foreign investors.<sup>35</sup> Under the VIE structure, there is no obligation of the parent company to notify foreign investors of these kinds of decisions, which can prove very costly for them. As a result, Yahoo! lost out on any direct benefit from launching Alipay, and Ma was able to seize the business without any knowledge or input from Alibaba's foreign investors.

Most recently, Alibaba's decision to launch its IPO in the United States instead of Hong Kong is noteworthy. In order to consolidate control over the company in the hands of the original founders, Alibaba has insisted on using a preferential stock structure in which investors will have no decision-making authority over the business.<sup>36</sup> That authority remains with the management in China. Hong Kong regulations currently do not permit publically traded companies to use preferential stock structures, which Alibaba set as a precondition for listing there. Given the large size of the Alibaba IPO, Hong Kong regulators were under investor pressure to revise the rules to accommodate Alibaba. But Hong Kong decided ultimately to retain its rules that guarantee equal voting rights for shareholders.<sup>37</sup>

Because the United States permits unconventional stock structures as long as they are disclosed in SEC filings, Alibaba chose to file for its IPO in New York.<sup>38</sup> Preferential stock structures are not uncommon in the U.S. Internet sector, and there is nothing inherently bad about them. However, investors in U.S.-based companies that use preferential stock structures have the strength of the U.S. judicial system as a safety net if the listed company attempts to steal investments or engage in other unlawful activities. In the case of Alibaba, as well as other Chinese companies listed on U.S. exchanges, U.S. investors would need to rely on China's judicial system to seek remedy for any unlawful acts. The Communist Party-controlled judicial system has an inconsistent record in securing the rights of foreigners in disputes with Chinese entities.<sup>39</sup>

### *Risks Related to Corruption and Internet Censorship*

Another factor that U.S. investors should consider is the possibility and consequence of Chinese Internet companies engaging in corrupt practices, especially those associated with Internet censorship in China. Corruption is prevalent in China and makes doing business there challenging for those who resist engaging in shady practices.<sup>40</sup> In its *China Business Report 2013-2014*, the American Chamber of Commerce in Shanghai reported that the problem of corruption and fraud is one of the top five challenges for American companies in China, with 82 percent of member companies surveyed saying that the frequency of corruption and fraud encountered was at the same level or increasing since the previous year.<sup>41</sup>

Employees of Chinese Internet companies often accept bribes for removing embarrassing or accusatory information from the Web.<sup>§42</sup> Although the Chinese government itself censors the Internet through official channels under Chinese law, often removing criticism of top government and party officials, an alternate for aggrieved officials accused of wrongdoing by netizens using social media also exists. This unofficial system of censorship is also widespread and generally involves government officials, companies, or private citizens paying bribes to employees of Internet companies to remove negative information about them from the Internet. There have been multiple cases of this kind of bribery, and it is a growing black market industry in China.

For example, in August 2012, three Baidu employees were arrested for taking bribes of about \$96 to remove defamatory online comments about government officials and companies. Subsequently, the average bribe for content deletion on Baidu rose to about \$386. Some reports claim that for a larger fee (about \$4,800), content can be deleted across all Internet portals.<sup>43</sup> In another case, former General Manager of Alibaba Yan Limin was arrested in August 2013 on suspicion of accepting two bribes in the form of expensive cars while employed by the e-commerce firm.<sup>44</sup> Several other Alibaba employees were also found guilty of related corruption and bribes.<sup>45</sup> Alibaba fired Yan prior to the arrest and issued a statement that it does not tolerate “behavior of this sort.”<sup>46</sup> However, Alibaba has other fraudulent activity in its recent history. For example, in 2011, about 100 Alibaba employees used the company’s online trading platform to assist in making false stock listings for personal gain.<sup>47</sup>

Most recently, a market has developed in China of “Internet PR agencies” or “dark PR agencies” that facilitate exchanging bribes for unofficial censorship.<sup>48</sup> In some cases, these agencies are intermediaries for the payment of bribes between Internet company employees and government officials. In other cases, the PR agency conducts the censorship itself. One example was the firm Yage Time founded by former Baidu employee Gu Dengda. Gu understood the Internet censorship infrastructure from his experience at Baidu and used that knowledge to censor information for private or government entities in exchange for a fee. According to a former Yage Time employee, 60 percent of the company’s business was from “minor government functionaries deliberately seeking to erase local whistle-blowing reports.”<sup>49</sup>

In their SEC disclosures, Chinese Internet companies are not required to and generally do not reveal any history of corruption or bribery nor do they describe how they use the Chinese government’s censorship infrastructure to engage in unofficial censorship. However, Chinese Internet companies listed on U.S. exchanges<sup>§\*</sup> fall under the jurisdiction of the U.S. Foreign Corrupt Practices Act (FCPA) even for acts of corruption that take place outside United States.<sup>50</sup> For example, under the FCPA’s accounting provisions, bribes, including foreign bribes, that are mischaracterized in a company’s financial records are in violation of Section 13(b)(2)(A) of the Securities Exchange Act of 1934.<sup>51</sup> In addition, failure to properly disclose material information

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<sup>§</sup> Unofficial censorship refers to the censoring of information by individuals either affiliated or unaffiliated with the Chinese government for personal benefit. Official censorship would include any censorship directed officially by the Chinese government; Internet companies in China are required by law to conform to official censorship regulations.

<sup>\*\*</sup> Despite the tiered nature of the VIE scheme, such acts of accounting fraud at any level of the corporate structure of a U.S.-listed Chinese company would fall under the jurisdiction of the FCPA.



about the company's business, "including material revenue, expenses, profits, assets, or liabilities related to bribery to foreign government officials" is in violation of the FCPA.<sup>52</sup>

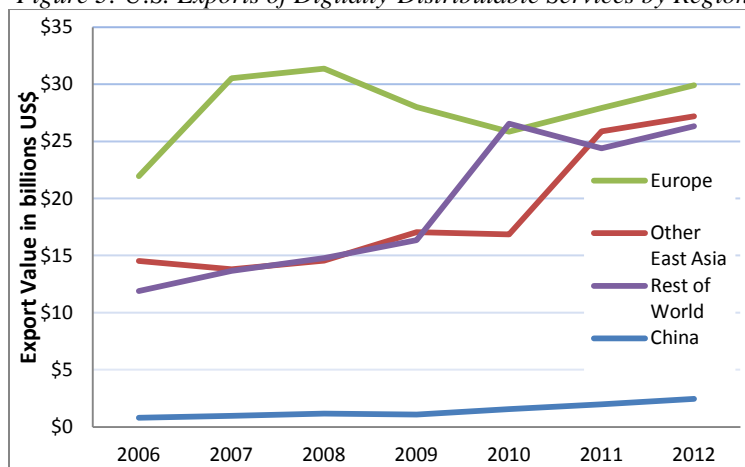
## Conclusions

Despite the risks outlined above, some securities analysts claim that VIEs, in theory, are not inherently risky. In fact, some analysts argue that VIEs are the only reasonable mechanism to bring foreign investment into China's Internet sector. Moreover, it is not VIEs themselves but rather Chinese government policies that are the true source of the problem: a lack of enforceability in Chinese courts. Thus, in seeking to reduce the risks of Chinese VIEs on U.S. exchanges, the United States should engage China to remedy the following more fundamental problems:

### *1. Unequal Access for Foreign Digital Services in China*

The U.S. has a global competitive advantage in services, especially information and communication technology (ICT), and certain services that can be distributed digitally, such as music, movies, and other forms of intellectual property.<sup>††</sup> According to a U.S. Department of Commerce study, in 2011, ICT-related services made up over 60% of U.S. services exports and 17% of overall exports, with demand concentrated in Europe and East Asian markets.<sup>53</sup> Yet, U.S. service exports to China in these sectors have remained extremely low. For example, in 2012 less than 3 percent of U.S. exports in digitally-distributable services were bound for China.<sup>54</sup> This disparity is illustrated in Figure 3.

Figure 3: U.S. Exports of Digitally-Distributable Services by Region



Source: Bureau of Economic Analysis, U.S. Department of Commerce.

This trade imbalance is due largely to Chinese restrictions on the free flow of information over the Internet, specifically the requirement that Internet companies be majority owned by Chinese nationals. These restrictions are the main reason why Chinese Internet companies must establish

<sup>††</sup> "Digitally-distributable services" refers to any service for which digital distribution has become commonplace. Data reflecting digitally-distributable services are composites of computer and information services, telecommunications services, advertising services, and royalties and licensing fees. Though these services may be distributed in other forms, they can and often are distributed digitally.

VIEs to list on U.S. exchanges. Eliminating these restrictions would greatly reduce the need to establish VIEs.<sup>††</sup>

## *2. Restricted Financial Markets in China*

China's restricted financial markets make it very difficult for Chinese firms to list domestically or to list directly on overseas exchanges. As a result, Chinese Internet companies in need of financing have little choice but to use the VIE structure to obtain foreign capital. Therefore, China's restricted financial markets not only create unnecessary risks for investors by forcing companies into VIE structures, they also limit the growth potential of Chinese Internet companies that could more efficiently access capital by listing domestically or directly overseas rather than via VIEs. Liberalization of financial markets, therefore, would also reduce the need to establish risk-ridden VIE structures.

## *3. China's Rudimentary Rule of Law*

Chinese VIEs are excessively risky precisely because the legal contracts upon which the structure is based are enforceable only in China, where rule of law remains underdeveloped. Investors have little faith that raising grievances through the Chinese judicial system will lead to a fair ruling, particularly when the complainant is foreign. Improved rule of law would encourage U.S. investors that they can fairly file complaints through the Chinese legal system.

## *4. Ambiguity Surrounding the Legality of VIEs in China*

While some Chinese government agencies have indicated that the VIE structure is illegal in China, the Chinese government, in practice, has allowed them to exist. This legal ambiguity contributes to the risk born by foreign investors, who are unsure if or when the Chinese government may begin to enforce its previous statements that VIEs are illegal. Clarification from the Chinese government on the legal status of VIEs would help reduce uncertainties among foreign investors.<sup>§§</sup>

The VIE structure does not appear to be a sustainable model if major Chinese companies continue to list on U.S. exchanges. If U.S. investors continue to buy into such Chinese VIE schemes and the system collapses, the scenario could be akin to the 2001-2011 Chinese reverse-merger debacle that cost U.S. investors an estimated \$18 billion.<sup>55</sup> If China were to enforce its laws and ban VIEs, the result would be a short-term loss for the foreign investors involved as well as the Chinese and foreign firms that use them to operate in China. If China maintains the foreign equity restrictions that compel firms into the legal ambiguity of the VIE structure, the potential result is a more extensive loss in which U.S. and other foreign Internet and ICT services firms have no legitimate access to compete fairly in the Chinese market, and Chinese firms will continue to resort to legally questionable methods to obtain foreign capital.

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<sup>††</sup>Since China's accession to the WTO, the United States has continuously pressed China to relax restrictions that ban or severely limit foreign investment in Internet and ICT-related service sectors; however, little progress has been achieved.

<sup>§§</sup> In seeking such clarification from the Chinese government, an unintended consequence may be a crackdown on foreign Internet companies that use the VIE structure to access the China market. Companies that use VIEs to invest in China are disinclined from supporting any policy efforts that might bring unwanted Chinese government attention to their legally questionable corporate structures.

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